argued in several CMRS rulemakings and PacTel's PCS licensing proceeding that the Commission lacks jurisdiction over financial arrangements between LECs and PCS providers regarding compensation for termination of either intrastate or interstate traffic.[103/]

However, PacTel recently filed a Motion before the California PUC in which it seeks a ruling that the California PUC's required approval of financing transactions for the acquisition, construction and expansion of its PCS network in California is preempted by Section 332 of the 1993 Budget Act as a CMRS entry regulation.[104/] Therefore, PacTel has staked out a flatly contradictory position before the Commission that financial arrangements between its LEC operations and its PCS affiliate are largely intrastate concerns, in contrast to

---

103/ In its Opposition to Petitions for Reconsideration of the Second CMRS Report and Order filed by MCI Telecommunications Corporation ("MCI"), and McCaw Cellular Communications, Inc. ("McCaw") seeking clarification that mutual compensation applies to both interstate and intrastate LEC-PCS traffic, PacTel argued that the Commission "lack[s] authority over intrastate carrier-to-carrier financial arrangements for the termination of mobile services." See Pacific Bell and Nevada Bell, Opposition to Petitions for Reconsideration, at 23-4 n.68 (filed on June 16, 1994 in Second CMRS Report and Order, GN Docket No. 93-252) (citing Indianapolis Tel. Co. v. Indiana Bell Tel. Co., 2 FCC Rcd 2893, 2894 (1987)). PacTel also recently argued that the "Commission should reiterate that its statements on mutual compensation are limited to the interstate jurisdiction and that it is not preempting state interconnection rates in any way." See Pacific Bell, Nevada Bell, Pacific Bell Mobile Services, Reply Comments, at 10-11 (filed on October 13, 1994 in Equal Access and Interconnection Notice, 9 FCC Rcd 5408 (1994)); see also Pacific Telesis Mobile Service, Opposition to Cox's Petition to Deny or Condition Grant, at 7-8 (filed May 25, 1995) (PacTel asserts that the Commission has not issued any decision or guidelines on how mutual compensation should be implemented on an interstate basis).

104/ See Memorandum of Pacific Bell Mobile Services (U-4135-C) and Pacific Telesis Mobile Services in Support of Motion for an Order That Any Commission Approvals of the Financing Transactions for its PCS Network Are Preempted by the Federal Communications Act (filed on June 19, 1995 in Investigation on the Commission's Own Motion into the Mobile Telephone Service and Wireless Communications, I.93-12-007).

its representations to the California PUC that State approval its of financial arrangements regarding PCS networks is preempted by the 1993 Budget Act.

The Commission should not be duped by PacTel's rhetoric into viewing mutual compensation as primarily an intrastate issue. The only reason, to paraphrase PacTel's assertion, that "mutual compensation is an area fraught with misunderstanding" is that PacTel has taken this position to maintain for itself the obvious benefit of a one-way payment regime.

The Commission's existing rule on mutual compensation and the public interest goals it represents justify assertion of Federal jurisdiction over LEC-PCS mutual compensation arrangements.[105/] The Commission may assert its statutory authority over conflicting State regulation where the interstate and intrastate portions of a service are inseverable.[106/] Moreover, in deference to a customer's right to interconnect with the public switched telephone network, the courts have upheld Commission authority to preempt state regulation of network interconnection policies where the interconnected facilities are used inextricably for both interstate and intrastate calls.[107/]

105/ See 47 C.F.R. § 20.11. This rule does not distinguish between interstate and intrastate traffic and makes mutual compensation a baseline requirement for all LEC interconnection agreements.

106/ See Louisiana Public Service Comm'n v. FCC, 476 U.S. 355, 375 (1986).

107/ See, e.g., North Carolina Util. Comm'n v. FCC, 537 F.2d 787, 793 (4th Cir.), cert denied, 429 U.S. 1027 (1976) (Commission has jurisdiction to determine what terminal equipment can safely and advantageously be interconnected with the interstate communications network and how that should be done); Puerto Rico Tel. Co. v. FCC, 553 F.2d 694 (1st Cir. 1977) (Commission may preempt inconsistent state interconnection regulations for PBX equipment).

Mutual compensation for LEC-PCS interconnection is primarily an interstate issue.[108/] Because the Commission consistently has viewed mutual compensation as an essential component to the buildout of a wireless "network of networks," the Commission would be justified in preempting conflicting State mutual compensation mechanisms.[109/]

The Commission licensed broadband PCS in larger MTA and BTA regions to "promote 'the rapid deployment and ubiquitous coverage of PCS and a variety of services and providers,' as MTAs and BTAs were designed based on the flow of commerce."[110/] Due to the predominantly interstate MTA regions, a significant portion of PCS traffic will be interstate rather than intrastate. If preemption is not the Commission's preferred policy choice there are other alternatives. As it has been implemented in other services, the Commission could require the implementation of a general allocator to distribute the majority of LEC-PCS mutual compensation to the Federal jurisdiction.[111/]

108/ Accepting PacTel's own admission, the "amount of confusion that exists with respect to the application [of] mutual compensation principles in the area of interstate interconnection" evidences the inseverability of the interstate and intrastate portions of such LEC-PCS transactions. See PacTel Opposition to Cox's Petition to Deny or Condition Grant, at 7.

109/ The Commission has asserted plenary jurisdiction over LEC-to-cellular interconnection. 1987 Cellular Interconnection Order, 2 FCC Rcd at 2912.

110/ See Equal Access and Interconnection Notice, 9 FCC Rcd at 5435-6 n.124 (quoting Second Broadband PCS Order, 8 FCC Rcd at 7732).

111/ Pacific Bell's intrastate expanded interconnection tariff, for example, provides that:

> Expanded Interconnection Service (EIS), except for the EISCC, is classified as interstate when the service carries more than a de minimis amount of interstate traffic. Interstate traffic is deemed more than de minimis when the interstate traffic amounts to greater than ten percent (10%) of the total traffic (and not the number of EISCCs) on an Expanded Interconnection Service . . . .

(continued...)

In sum, PacTel's conflicting positions depending upon whether it is talking to the FCC or state regulators raises substantial questions regarding the effectiveness of its PCS Plan. Without additional conditions to require PacTel to provide mutual compensation at the Federal level, and an expansive approach to what constitutes interstate jurisdiction, approval of the existing Plan would only reward PacTel for its recalcitrance. The Commission should assert jurisdiction over LEC-to-PCS interconnection, including the rates for interconnection, to prevent PacTel from engaging in jurisdictional gamesmanship.

D. The Commission Must Consider the Broader Effects of PacTel's Interconnection Arrangements Upon the Public Interest

In an era of megamergers, heightened concentration of ownership interests and shattering of traditional private sector boundaries among landline telephony, wireless, cable and broadcast operators, the Commission must consider whether a slavish adherence to outmoded regulatory constructs will only harm competition by solidifying the monopoly position of incumbent LECs. Continued application of non-structural safeguards so ill-suited to present circumstances will enable PacTel, as one of the primary gatekeepers to the public switched telephone network, to run roughshod over PCS competitors and impose monopoly-bargaining power to dictate terms, conditions and refusals of reasonable interconnection almost at will. Absent fortified regulatory safeguards. the interconnection arrangements

---

111/ (...continued)

See Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1811, at Section 2.3.18, p.36.2.3 (filed May 25, 1995); see also Pacific Bell Revisions to Tariff F.C.C. No. 128, Order, CC Docket No. 93-162, DA 95-1521 (released July 7 1995).

between PacTel and PCS licensees will not ensure the evolution of a wireless "network of networks."

The Commission has acknowledged that, given the importance of access to reasonable and nondiscriminatory interconnection arrangements,[112] LECs with CMRS affiliates have a greater incentive to discriminate against non-affiliated CMRS competitors.[113] PacTel's huge investment in deployment of its PCS affiliate and in fending off challenges to its existing local monopoly gives it a major incentive to engage in unreasonably discriminatory interconnection practices with regard to unaffiliated PCS licensees, including unreasonable refusal to provide interconnection as identified by the Commission.

112/ See Interconnection and Resale Obligations Pertaining to Commercial Mobile Radio Services, Second Notice of Proposed Rulemaking, CC Docket No. 94-54, at ¶ 31 (released April 20, 1995) (In tentatively concluding that no general interstate interconnection obligation should be imposed upon CMRS providers, the Commission observed that "[w]ith interconnection available through the LEC , no CMRS carrier can limit the service that another can offer").

113/ The Commission observed:

> Unlike independent CMRS carriers, LEC-affiliated CMRS carriers may have a unique incentive to deny interconnection so as to keep CMRS-to-CMRS traffic interconnected through the local exchange landline network, and to continue to collect CMRS interconnection charges from both sets of CMRS providers through their access charge structure. Such LEC ownership may play an important role in assessing whether a denial of interconnection is a reasonable business decision or a form of anticompetitive conduct intended to raise rivals' costs of doing business and hence hinder competition.

See id. at ¶ 43.

Discrimination is a certainty under PacTel's Plan. For example, PacTel claims that allowing only PBMS to have physical collocation of its facilities, as well as operational, installation and repair crews at PacTel's end offices, does not give it any "pricing advantage" over other CMRS providers because their interconnection at a remote serving wire center is "distance insensitive." This is not the case. PacTel's integration and physical collocation of its landline monopoly end offices, regulatory staff, financial arrangements, maintenance and repair staff, mobile switching, and interconnection hardware and software will give it an unfair competitive advantage over similarly situated but non-affiliated PCS providers seeking to interconnect on terms and conditions that are comparable in terms of price, features and scope. Under the Commission's expanded interconnection rules, interconnectors are entitled to the same type, nature and scope of interconnection as similarly situated interconnectors, and all interconnectors should have access to the same interconnection as PBMS.[114]

114/ See Expanded Interconnection with Local Telephone Company Facilities Memorandum Opinion and Order, 9 FCC Rcd 5154 (1994) ("Virtual Collocation Remand Order"). In addition, PacTel's claim that its use of strategically priced discounts for long-term contracts is not discriminatory is incorrect. Under expanded interconnection, LECs are prohibited from implementing volume *or* term discounts unless they have first established a specified number of cross-connects to competitive access providers. Expanded Interconnection With Local Telephone Company Facilities, Transport Phase I, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7434-35 (1993). Absent facing sufficient competition from alternative access providers, there is no guarantee that PacTel will not engage in anticompetitive practices rather than strategic pricing of volume and term discounts. Indeed, the Commission has ordered LECs identified as offering the steepest volume and term discounts to submit cost data to demonstrate whether the rates covered are average variable costs and were otherwise reasonable and vowed to "continue to examine LEC pricing behavior in the future [and] be vigilant in examining any evidence of unreasonable pricing practices on the part of the LECs." See Virtual Collocation Remand Order, 9 FCC Rcd at 5201.

Approval of a Plan in which PacTel integrates PCS and wireline telephony offerings will set an important precedent for existing and future integrated landline and wireless ventures. The impact that integration of LEC landline and wireless operations will have on the type, nature and scope of interconnection that non-LEC affiliated wireless competitors will be able to obtain from LECs is enormous. Absent sufficient competition or a revamped Plan that creates effective safeguards, PacTel will integrate its PCS offerings with local and long distance wireline telephony service with virtually free rein to restrict the terms and conditions of access to the local exchange network by non-affiliated PCS providers. The Commission must develop safeguards that address these issues.

The Commission should, for the purposes of fostering wireless interconnectivity, impose affirmative conditions on PacTel through the Plan approval proceeding to: (i) comply with existing rules requiring good-faith negotiation of interconnection arrangements; (ii) provide meaningful cost support to justify any interconnection arrangements it offers to its PCS affiliates; (iii) demonstrate, by means of a certified interconnection agreement with a non-affiliated PCS provider, that it faces demonstrable competition from a facilities-based competitor prior to its implementation of downward pricing flexibility mechanisms (such as the term discount proposed in the Plan); (iv) make mutual compensation available to affiliated and non-affiliated PCS providers for termination of one another's traffic; and (v) meet its long-standing common carriage obligations, as reflected recently in the Commission's ONA and expanded interconnection proceedings, to make the same terms, conditions and type of interconnection available to non-affiliated PCS competitors that it makes available to its own PCS affiliate. These initial remedial measures are necessary, at a minimum, to limit the potential for PacTel to extend its monopoly power in the landline bottleneck to impede competition in wireless markets. Fundamentally, the Commission must take steps to ensure PCS is not marginalized as a local loop competitor simply because PacTel has a PCS affiliate and is willing to forego providing that affiliate efficient and reasonable interconnection as the price of maintaining its core monopoly. If the Commission allows this behavior to unfold, its PCS vision will be a failure.

V. CONCLUSION

PacTel's proposed "safeguards" are insufficient to protect competitors from abusive treatment and the rate-paying public from cross-subsidy. Meaningful safeguards are required to preserve PCS as a competitive alternative to wireline and cellular-based telephony services in the greater California/Nevada markets. Concern for competition without action could be interpreted as lack of Commission resolve: without Commission action true competition to the local loop cannot occur.

Despite its past promises to institute rulemakings on the necessary competitive safeguards for in-region LEC provision of PCS, the Commission has continually deferred action. PacTel now has in-region 30 MHz PCS licenses for California and portions of Nevada, one of the most populous markets in the country. The Commission has before it a non-structural "safeguards" plan that fundamentally fails to propose effective safeguards against the cross-subsidy and discrimination, incentives the Commission readily acknowledges exist where a LEC integrates landline monopoly and PCS functions. This is hardly surprising given the vagueness of the Commission's direction and the unfortunate fact that the task of drafting safeguards was handed to the self-interested LEC

PacTel's Plan is demonstrably deficient Not only can PacTel discriminate without detection in favor of its PCS affiliate, PacTel has ignored basic Commission requirements of good faith negotiation for the differing forms of interconnection CMRS carriers desire. There is nothing in PacTel's Plan to prevent PacTel from loading fully distributed costs, including apparently the costs of interconnection, on its PCS competitors, while at the same time using its "economies of scope" to provide its PCS affiliates access to AIN and other network functions on far more favorable terms. PacTel's non-structural safeguard Plan should be rejected and the Commission should formulate the ground rules for integrated LEC provision of in-region PCS.

These ground rules must reflect a sensitivity to the LECs' inherent incentive to stifle competition in the core LEC monopoly market. LEC abuse of non-structural safeguards is well documented, and the application of non-structural safeguards and Part 64 of the Commission's rules will not provide meaningful review of PacTel's PCS activities. Congress, in its pending legislation, has determined that structural separations protections are deregulatory and pro-competitive, and the Ninth Circuit has put the Computer III rules in doubt. The Commission must re-visit the adequacy of non-structural safeguards to govern in-region LEC participation in an industry with as many critical competitive implications as PCS.

At a minimum, safeguards for in-region LEC provision of PCS must include ongoing disclosure of all financing, compensation and support and supply contracts between the LEC and its PCS affiliates Financial disclosure must be on a line-item basis for the PCS licensee and all LEC affiliates involved with PCS A new Part 64 category for PCS investments should be established and the Commission must give new direction on what costs are PCS costs to ensure that monopoly telephone ratepayers are not saddled with costs that should be allocated to PCS

Interconnection must be non-discriminatory, with the same rates, terms and conditions available to all, and the Commission must assert federal jurisdiction over interconnection to ensure that some form of mutual compensation finally is paid by PacTel. Most importantly, the Commission cannot overlook the potential of PCS as a local loop competitor. All of the safeguards that the Commission develops must be geared to encouraging this competition. If adequate competitive safeguards are not enacted soon, the years the Commission has devoted to introduce PCS as a local loop competitor will be wasted.

Respectfully submitted,

COX ENTERPRISES, INC.

Laura Phillips

Werner K. Hartenberger
Laura H. Phillips
Peter A. Batacan
Christina H. Burrow

Its Attorneys

DOW, LOHNES & ALBERTSON
1255 Twenty-Third Street, N.W.
Suite 500
Washington, D.C. 20037
(202) 857-2500

August 16, 1995

APPENDIX A

DOW, LOHNES & ALBERTSON

ATTORNEYS AT LAW

1255 TWENTY THIRD STREET

WASHINGTON, D.C. 20037-1194

LAURA H. PHILLIPS
DIRECT DIAL NO.
857-2824

TELEPHONE (202) 857-2500
FACSIMILE (202) 857-2900

June 28, 1995

VIA MESSENGER

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street
Washington, D.C. 20554

EX PARTE

Re: CC Docket No. 87-266
CC Docket No. 94-1

Dear Mr. Caton:

Enclosed please find two copies of a letter from James O. Robbins, President and CEO, Cox Communications, Inc., to Honorable Reed E. Hundt, Chairman of the Federal Communications Commission delivered today to Chairman Hundt, Commissioner Quello, Commission Barrett, Commissioner Ness and Commissioner Chong. Please add this letter to the record in the above-referenced dockets.

Please contact the undersigned should you have any questions with regard to this filing.

Sincerely,

Laura Phillips

Laura H. Phillips

cc: Chairman Hundt
Commissioner Quello
Commissioner Barrett
Commissioner Ness
Commissioner Chong

James O. Robbins
President and Chief Executive Officer

Cox Communications, Inc
1400 Lake Hearn Drive NE
Atlanta, Georgia 30319
(404) 843-5811

COX COMMUNICATIONS

June 28, 1995

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, NW, Room 814
Washington, D. C. 20554

Dear Mr. Chairman:

Much is made about an assertion that price cap regulation of LECs eliminates their incentive to cross subsidize new services from their monopoly rate base. Flowing from this assertion, it is argued that there is no need for the FCC to impose reasonable cost allocations between telephony and video dialtone services because price caps eliminate cross-subsidies.

Enclosed is a white paper by Snavely King and Associates which debunks this assertion whether it is based on: (1) the FCC's existing price cap regime; or (2) a theoretically reformed FCC "pure" price cap regime in which sharing options are eliminated.

First, the FCC's existing price cap regime permits LECs to game the system by moving from high price caps with no sharing to lower price caps with sharing as their anticipated revenues and future sharing obligations dictate. If LECs misallocate costs to telephony, thereby artificially depressing telephony earnings, virtually all of the productivity benefit from the price cap is lost. In other words, under the existing Commission's price cap regime, the LECs have every incentive to transfer virtually all of the costs of VDT to their captive rate base.

Second, even if the Commission reforms its existing price cap regime to eliminate the sharing options, some adverse effects of cross-subsidy from improper cost allocation will remain because the misallocation of common costs to telephony always will deflate the productivity factor and offset the expected decline in regulated telephone costs to consumers.

Third, under existing jurisdictional separations rules, state regulators face 75% of the consequences of cost misallocation to telephony without any remedy under the VDT tariff process. Moreover, many state regulators face changes in state law which, under reform of state price caps, forbid the collection of cost and revenue data needed to address the local VDT cross-subsidy issues.

Cost accounting without cost allocation is like Yin without Yang. The responsibility to confront and decide this fundamental public policy issue quite simply cannot be avoided by claiming price caps prevent cross-subsidy since, as our analysis shows, they do not. In light of this reality, the Commission should immediately take several concrete steps to protect telephone ratepayers: (1) revise Part 64 and 36 accounting rules to separate all video dialtone costs from telephone costs prior to the jurisdictional separation process; (2) determine a reasonable allocation of common costs that must be applied in all VDT tariffs; and (3) impose procedures that exclude VDT from price caps and from all price cap productivity factor calculations.

Sincerely,

Jim Robbins

Enclosure

cc: The Honorable James H. Quello
The Honorable Andrew C. Barrett
The Honorable Rachelle B. Chong
The Honorable Susan Ness

Effect of Video Dialtone Cross-Subsidies on Price Cap Carriers

Report by
Snavely, King & Associates, Inc.
to Cox Enterprises, Inc.

The video dialtone systems proposed by a number of Local Exchange Carriers ("LECs") are not profitable. In LEC filings, common video/telephony costs and corporate overhead costs are underassigned to video dial tone. As these video dialtone systems are built, they will be financed and sustained by heavy cross-subsidies from telephony operations.

The argument has been made that cross-subsidies are of no consequence to ratepayers of monopoly telephone services because the "price cap" scheme adopted by the Federal Communications Commission ("FCC") insulates consumers from the effects of misallocations. Telephone ratepayers, it is argued, are protected from any effects of overstated costs, including cross-subsidies of video dialtone services, because the LEC's actual costs and productivity are not used in the formula for updating the price cap. The formula simply subtracts the productivity option chosen by the LEC from the inflation rate (see Figure 1 attached for options).

The way this consumer insulation is supposed to work is illustrated by Figure 2. A carrier electing the "pure" price cap option (i.e. no requirement to share profits above a certain amount with ratepayers) must offset inflation by an annual productivity factor of 5.3 percent, but it may keep any earnings it can achieve. Inflation is assumed to be 3.3 percent annually in this illustration. Therefore the price cap index declines 2.0 percent each year. This is the rate by which the hypothetical carrier must reduce its telephone rates.

The illustration continues by assuming that the carrier actually achieves a 5.3 percent productivity and thus earns 13.65 percent each year. However, the rate of return, whatever it is, has no bearing on the movement of the price cap index.

There are three reasons why the argument illustrated by Figure 2 is wrong, and why video dialtone cross-subsidies do affect telephone ratepayers. The three reasons relate to (1) jurisdictional separations, (2) interstate profitability, and (3) industry productivity.

1. Jurisdictional Separations

By law, the FCC must separate the costs of telephony between interstate and intrastate services. At present, there is no formal recognition of video dialtone services in the Part 36 separations rules. To date the allocation of costs for video dialtone are following the allocations contained in the LECs' proposed video dialtone tariffs. If these proposed tariffs understate the cost of video dialtone, they overstate the cost of telephone services. Existing separations procedures (Part 36) allocate approximately 75 percent of telephone service costs to the intrastate jurisdiction. Thus, each $1.00 overstatement of telephone costs by reason of video dialtone cross-subsidies inflates intrastate jurisdictional costs by 75¢.

Whether or not a carrier chooses the no sharing "pure" price cap option for interstate services has absolutely no effect on intrastate ratemaking. The only way to protect intrastate telephone ratepayers from paying for video dialtone subsidies is to ensure that intrastate telephone costs do not include video dialtone costs. To address this issue, the Commission should revise its Part 64 accounting rules to separate <u>all</u> video dialtone costs from telephone costs before these costs are separated by jurisdiction. This will ensure that no video dialtone costs will be supported by intrastate telephone ratepayers.

2. <u>Interstate Profitability</u>

According to LEC tariff filings, the provision of video dialtone service in the initial years will increase costs more than revenues. This early unprofitability will influence the LECs' choice of price cap options. As discussed above, the "pure" price cap option requires a 5.3 percent productivity offset and results in an annual rate reduction of 2.0 percent. However, if the carrier anticipates that video dialtone will lower its overall profits, it will not opt for the "pure" price cap option, but will choose one of the "sharing" options that does not carry such a high productivity offset. The carrier will opt for the price cap option which minimizes its total rate reduction requirement as a result of both the formula and sharing. The carrier will choose the lowest productivity offset available, unless this choice will cause it to lower rates more through sharing than it avoids by choosing a low productivity offset.

In Figure 3, it is assumed that the carrier initially earns 13.65 percent, which is above the 12.25 threshold for sharing under the two sharing options. However, consistent with the data from LEC tariffs, Figure 3 assumes that video dialtone costs reduce realized productivity by 3.0 percent to 2.3 percent. This drop in productivity will cause lower earnings. Anticipating this, the carrier will choose the 4.0 percent productivity factor, the lowest price cap productivity option. This choice produces a net annual price reduction of only 0.7 percent. Under this option, the carrier must share earnings between 12.25 and 13.25 percent on a 50/50 basis, and it must refund all earnings greater than 13.25 percent. In this illustration, video dialtone service has reduced the carrier's return to 12.80 percent. Therefore, sharing deprives the carrier of only .275 percent [1] of its earnings in the first year. In the second and third years, video dialtone further depresses earnings to 11.95 percent and 11.10 percent, respectively, so the carrier shares no earnings whatever.

Since carriers choose one of the three price cap options each

---

[1] 12.80%-12.25% = .55% x 50% = .275%

year, the advent of video dialtone will likely result in a migration of LECs from the highest productivity, non-sharing option to the lower productivity, sharing options. As demonstrated by the first three years of Figure 3, the effect on ratepayers is an annual price cap adjustment that is 1.3 percentage points higher with video dialtone than without it.

The Commission can insulate interstate telephone ratepayers from this effect by imposing procedures to exclude video dialtone revenues and costs from the earnings that are used to compute the sharing obligation. However, if there is a cross-subsidy, and a portion for the common costs that should be assigned to video dialtone are assigned to telephone services, this exclusion fails to resolve the problem. Telephone service earnings will decline, and carriers will opt for the lower price caps in the confidence that they will not become subject to earnings sharing.

3. Industry Productivity

In its recent price cap order, the Commission found merit in basing the productivity offset in its price cap mechanism on a moving 5-year average of the industry's productivity performance. The effect of adding significant new video dialtone inputs without a corresponding (in the near term) increase in outputs will be to reduce the industry's productivity performance. The moving average of productivity performance will decline, and with it the productivity offset.

The consequence of this effect is illustrated in Figure 3 in Years 4, 5, and 6. Figure 3 assumes that in Year 4 the Commission observes that the industry's productivity performance has fallen to 2.3 percent and the productivity offset is set at this level. Combined with an inflation rate of 3.3 percent, this offset allows an annual <u>increase</u> in rates of 1.0 percent, instead of the 2.0 percent <u>decrease</u> discussed above.

Again, the Commission can insulate telephone ratepayers from this effect by imposing procedures to exclude video dialtone inputs and outputs from the annual productivity performance calculation. However, if there are cross-subsidies, and video dialtone costs are allowed to inflate telephony inputs, then the telephone productivity factor will decline in spite of the Commission's efforts to segregate these two lines of business for purposes of rate regulation.

<u>Conclusion</u>

In the attached illustration, the cumulative six-year effect of video dialtone on interstate telephone ratepayer is an increase of 12.9 percent in their rates. With no video dialtone costs, rates fall by 12.0 percent, as shown on Figure 2. With video dialtone costs, rates increase by 0.9 percent. This is in spite of the fact that the hypothetical LEC began, in Year 0, as a "pure" price cap carrier. Moreover, even if the FCC changes its existing price cap plan by eliminating the sharing options altogether, the adverse effects of cross subsidy from improper cost allocation will persist. This is because the telephone productivity factor will be deflated as described above. Ultimately, without reasonable cost allocations, interstate and intrastate telephone ratepayers will bear the burden of supporting those cross-subsidies.

EFFECT OF VDT CROSS-SUBSIDIES ON PRICE CAP CARRIERS

Figure 1 - FCC Price Cap Options

PRODUCTIVITY FACTOR OPTION	EXCESS EARNINGS SHARED WITH RATEPAYERS
4.0%	50% of earnings between 12.25% and 13.25% 100% of earnings over 13.25%
4.7%	50% of earnings between 12.25% and 16.25% 100% of earnings over 16.25%
5.3%	No Sharing Required

EFFECT OF VDT CROSS-SUBSIDIES ON PRICE CAP CARRIERS

Figure 2-Base Case (5.3 percent productivity assumed)

YEAR	INFL	PROD	PRICE	ROR
0	-	-	-	13.65% *
1	3.3%	5.3%	(2.0%)	13.65%
2	3.3%	5.3%	(2.0%)	13.65%
3	3.3%	5.3%	(2.0%)	13.65%
4	3.3%	5.3%	(2.0%)	13.65%
5	3.3%	5.3%	(2.0%)	13.65%
6	3.3%	5.3%	(2.0%)	13.65%
TOTAL	-	-	(12.0%)	-

Figure 3-VDT Costs Added To Telephone (2.3 percent productivity assumed)

YEAR	INFL	PROD	PRICE	ROR
0	-	-	-	13.65%
1	3.3%	4.0%	(0.7%)	12.80%
2	3.3%	4.0%	(0.7%)	11.95%
3	3.3%	4.0%	(0.7%)	11.10%
4	3.3%	2.3% **	1.0%	11.10%
5	3.3%	2.3%	1.0%	11.10%
6	3.3%	2.3%	1.0%	11.10%
TOTAL	-	-	0.9%	-

* RBOC 1994 Actual (Authorized is 11.25 percent).
** Assumes productivity target lowered by 3.0 percentage points.
Note: This chart assumes FCC adopts rules to separate VDT from telephone costs for intrastate ratemaking.

APPENDIX B

Incremental Cost Of Local Usage

Gerald W. Brock
March 16, 1995
(Prepared for Cox Enterprises)

Summary

A reasonable estimate of the average incremental cost of local usage (and therefore the cost of terminating traffic received from a competitor) using digital technology is 0.2 cents per minute. That estimate is based on studies done by or supported by telephone companies. The cost is determined by peak period capacity and therefore the true cost is considerably higher than the 0.2 cents per minute average during the peak period and is zero during the non-peak period.

I. Introduction

In a separate paper prepared for Comcast, I have argued that the theoretically correct interconnection charge is cost based mutual compensation. However, cost can have many different meanings and in a regulatory context, cost based requirements can lead to interminable regulatory proceedings and disputes. Policy makers have consequently frequently sought structural methods of solving problems that do not require detailed oversight of cost rules.

One proposed structural rule is mutual compensation without oversight of actual rates, but as shown in the Comcast paper that approach is inadequate to limit the exercise of monopoly power. An alternative approach that dispenses with direct control of cost is the policy of "sender keep all" or "bill and keep" in which each party agrees to terminate traffic for the other without payment for terminating service. That is equivalent to mutual compensation with a zero price for compensation. It will be economically efficient if <u>either</u> of two conditions are met:

(1) Traffic is approximately balanced in each direction;
(2) The actual costs are very low so that there is little difference between a cost based rate and a zero rate.

Existing publicly available studies suggest that the incremental cost of local usage (and therefore the cost of terminating traffic from a competitor) is on average approximately 0.2 cents/minute. The actual cost is considerably higher during the peak period and zero during the off peak period. Thus it would not be efficient or desirable